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Securities Regulation—Private Offering Exemption: SEC Proposed Rule 146

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SECURITIES REGULATIONS—PRIVATE OFFERING EXEMPTION: SEC PROPOSED RULE 146.

The new, growing enterprise which seeks expansion capital in today's market is likely to find the process of raising capital traumatic. Prevailing high interest rates and stiff underwriting fees[1] for more risky enterprises may make the cost of capital prohibitive. Yet expansion is often essential to survival, and the sale of securities is often essential to expansion. Public registration of securities[2] requires expensive printing,[3] certification by accountants, and sometimes costly revision of an accounting system to generate the information required by detailed, often baffling, SEC requirements.[4] In addition, legal costs may run as high as ten percent of the offering amount.[5] It is particularly unfortunate that at such a critical juncture in the life of an enterprise current federal securities law results in imposition of heavy administrative costs associated with a public offering upon those very companies which federal antitrust law seeks to nurture. Some enterprises cannot afford the delay required by SEC registration;[6] others

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1. The underwriting cash discount or commission on a public securities offering may vary within a range of seven to ten percent of the public offering price. Schneider & Monko, *Going Public—Practice, Procedure and Consequences,* 15 VILL. L. REV. 283, 298 (1970). A particularly risky offering may elicit an underwriter's fee of thirteen percent or higher. Interview with Mr. Joel Starin, member, Washington Bar, and former SEC attorney, Seattle, Wn., May 1, 1973.

2. 15 U.S.C. § 77e(b) (1970) provides:

> It shall be unlawful for any person, directly or indirectly—
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

Section 5(c) of the Securities Act requires that a registration statement be in effect with the Securities and Exchange Commission before a security may be offered or sold to the public using any means of interstate commerce or the mails. This requirement is intended to ensure that investors are protected against fraud and misrepresentation by being informed of material facts concerning securities. S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933).

3. Schneider & Monko, *Going Public—Practice, Procedure and Consequences,* 15 VILL. L. REV. 283, 299 (1970). Printing fees vary widely but generally range from $15,000 to $20,000. If amendments and corrections to amendments are required or a last-minute rush causes the printer to work overtime, costs may exceed $30,000.

4. *Id.* Accounting fees also can vary widely depending upon the type of business involved, the sophistication of the accounting system, whether an audit previously has been performed, and other factors.

5. *Id.* at 298 (based on an offering of $200,000).

6. SEC processing time for registrations between initial filing and effectiveness may vary from two to six months. Telephone interview with Mr. Larry McKown, Office of Company Filings and Records, Securities and Exchange Commission, Washington, D.C., May 1, 1973.

may wish to avoid public disclosure of financial data, the added time and effort required of executives and/or the greater rigidity imposed on financing agreements which SEC registration may require.[7] Hence, in many instances the statutory exemptions from registration have become crucial to the acquisition of capital for expanding enterprises.[8]

The Securities Act of 1933 provides three important exemptions from its registration requirements which may apply to new enterprises. First, a small offering exemption is available.[9] However, its utility is limited in that only $500,000 can be raised over a two-year period. Second, through the intrastate offering exemption,[10] the Act exempts

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7. For example, a private placement financing arrangement may provide that increments may be borrowed as needed over an extended period. Similar public financing requires that each increment be registered separately.

8. These exemptions do not shield an issuer from the significant criminal and civil law deterrents of sections Twelve, 15 U.S.C. § 77q (1970), and Seventeen, 15 U.S.C. § 77*l* (1970). *See* notes 70 and 71 *infra*. Moore v. Gorman, 75 F. Supp. 453, 456 (S.D.N.Y. 1948). The SEC is opposed to exemption from registration in situations where the investor cannot "fend for himself" because it feels statutory registration and SEC scrutiny have value to the investor above and beyond that afforded by the antifraud provisions, as indicated by the remarks of G. Bradford Cook (former SEC Chairman) which were delivered to the Conference on Securities and Current Corporate Problems, Big Mountain, Whitefish, Montana, January 10-13, 1973. Mr. Cook stated that supervised disclosure provides more responsible and detailed disclosure, particularly because of the twenty day waiting period which delays effectiveness of registration statements and because of the preventive stop order available to the Commission. It is questionable whether these considerations outweigh the small issuer's interest in avoiding the extra expenses involved in registration. By using pro forma reports and opening his books to investors, the issuer's legal, accounting and printing fees can be minimized.

9. 15 U.S.C. § 77c(b) (1970) provides:

> The commission may from time to time by its rules and regulations . . . add any class of securities to the securities exempted as provided by this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue shall be exempted . . . where the aggregate amount at which such issue is offered to the public exceeds $500,000.

Pursuant to this statute, the Commission has adopted Regulation A, 17 C.F.R. § 230.254 (1972), which exempts securities where:

> (a) The aggregate offering price of all of the following securities of the issuer, its predecessors and all of its affiliates . . . shall not exceed $500,000.

10. 15 U.S.C. § 77c (11) (1970). This provision exempts:

> Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such securitiy is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

See generally Note, 40 U. CINN. L. REV. 779 (1971). For an argument that the intrastate offering exemption offers potentially less risk of liability than does the private offering exemption, *see* Mandel, *Intrastate vs. Private Offering: The Advantages of Focusing on An Often Blurred Distinction*, 46 L.A. BAR BULL. 101 (1971).

The SEC has recently promulgated Proposed Rule 147 to remove existing uncertainty securities offered solely within one state to residents of that state. This exemption provides a reasonable avenue for financing local enterprises with local sources of capital, but it does involve the risk that, unknown to the issuer, some purchasers may be nonresidents or may intend to resell to persons residing outside the state.[11] Either event will cause a loss of the exemption.[12] The exemption currently providing the most registration-exempt capital of any method of financing is the private offering exemption,[13] which covers transactions deemed not to involve a public offering.[14] While it offers an avenue to large amounts of capital, the exemption is fraught with problems. The applicable statutory language is vague, legislative history sparse,[15] and interpretive

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concerning the intrastate offering exemption. SEC Proposed Rule No. 147, 38 Fed. Reg. 2469 (1973). If adopted, the Rule would require that the transaction meet four conditions to be deemed exempt from the registration requirements of the Act: (1) the issuer must be residing and doing business within the State or Territory; (2) the offerees and purchasers must be resident within such State or Territory; (3) reoffers and resales must be limited to residents of that State or Territory for a period of twelve months after the date of the last sale of any part of the issue; and (4) precautions, including legends on securities, must be taken against interstate distribution. The Proposed Rule should bring greater certainty to this exemption, particularly by providing an objective waiting period test for redistribution. However, its requirement that the issuer "reside" within the State of the distribution will seriously restrict the scope of the exemption.

11. SEC Release No. 33-4434, 26 Fed. Reg. 11896 (1961).

12. *See, e.g.*, Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970); Hillsborough Inv. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960).

13. 15 U.S.C. § 77d(2) (1970) states that the registration requirements of the Act do not apply to "transactions not involving any public offering". *See generally* Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959); Comment, 86 HARV. L. REV. 403 (1972) and Note, 24 U. FLA. L. REV. 458 (1971). Data regarding the actual dollar amount of securities are necessarily estimates because issuers' reports on private placements are not filed with the SEC. Professor Goldberg has estimated that private placement securities constitute over half of all securities sold in the United States in recent years. 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 7 (1972). SEC estimates place the total dollars of capital raised by corporate private offerings in 1971 at $7.7 billion, $7.4 of which was estimated to have arisen from bond or debenture securities. SEC STATISTICAL BULLETIN 22-23 (February 1972). *See also* Comment, 86 HARV. L. REV. 403 n.3 (1972).

14. Although exempted as a private offering, an offering may run afoul of the resale restrictions of the Act. *See* 15 U.S.C. § 77d(1) (1970), which provides a limitation on private placements by "underwriters," defined as, *inter alia*, those who purchase from an issuer with "a view to distribution" rather than to investment, 15 U.S.C. § 77b(11) (1970). SEC Rule 144, 37 Fed. Reg. 396 (1972), provides an objective test of investment intent by requiring that a security coming within the private offering exemption be held by the purchaser for not less than two years before release. *See generally Symposium—A Guide to SEC Rule 144*, 67 NW. U.L. REV. 1 (1972) and Note, 81 YALE L.J. 1574 (1972). A detailed discussion of the resale problems is beyond the scope of this note.

15. The legislative history of the exemption provides little help in analyzing the provision. The basic policy of the Securities Act of 1933 was "that of informing the investor of the facts concerning securities to be offered for sale in interstate commerce...", S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). The House Report, H.R. REP. No. 85,

cases overladen with open-ended tests and broad ambiguities.[16] This situation has led to uncertainty as to the availability of the exemption among issuers.[17] The effects of this uncertainty may be far-reaching since if a private offering exemption is relied upon but not established, serious liability may result, including rescission of the offering, malpractice claims against the attorney and, in the event that a willful violation is found, criminal prosecution.[18] This note will examine the present ambit of the private offering exemption, consider proposed amendments to it and propose changes to clarify its application.

I. THE STATUTORY LANGUAGE

The statutory language does not define a private offering,[19] but tra-

73d Cong., 1st Sess. 5, 15-16 (1933), stated that "The Act carefully exempts from its application certain types of . . . securities transactions where there is no practical need for its application or where the public benefits are too remote . . . . [It] exempts transactions . . . to permit an issuer to make a specific or isolated sale of its securities to a specific person [but if the sale is] generally to the public, the transaction shall come within the purview of the Act." The Conference Report, CONF. REP. No. 152, 73d Cong., 1st Sess. 25 (1933), added that "sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a public offering." *See* SEC v. Ralston Purina, 346 U.S. 119, 122 (1953); 1 L. Loss, SECURITIES REGULATION 653 (2d ed. 1961); and Comment, 86 HARV. L. REV. 403, 405 (1972).

16. *See* text accompanying notes 28-42 *infra*. The uncertainty of section 4(2) is at least partially a reflection of the difficulty of construing broad, remedial legislation such as the Securities Act. In interpreting the Act, the courts have sacrificed clarity for flexibility in order to ensure the investing public a full measure of remedial protection. *See* Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1965); SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

17. The SEC has indicated that the availability of the exemption is esentially a question of fact and has cautioned issuers that an SEC no-action letter "may not be proof against claims by purchasers of the security that registration should have been effected." SEC Release No. 33-4552, 27 Fed. Reg 11316, 11317 (1962). Furthermore, the letter may not be binding on the SEC. *See* K. DAVIS, ADMINISTRATIVE LAW TEXT 118-20 (3d ed. 1972).

18. The issuer may be found criminally liable for willful violations of the Act under Section 24, 15 U.S.C. § 77x (1970). Criminal liability was imposed in *United States v. Custer Channel Wing Corp.*, 376 F.2d. 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967), *rehearing denied*, 389 U.S. 998 (1967). Even if willfulness is not established, further violations may be enjoined under Section 20, 15 U.S.C. § 77t (1970), and purchasers may obtain rescission or damages under Section 12, 15 U.S.C. § 77*l* (1970). For a discussion of liability where the private offering fails, *see* Harrison, *Thirty Eight Years Without Definition—The Private Offering Exemption*, 24 ARK. L. REV. 417, 434 (1971). For an argument that the general public may recover damages regardless of privity where securities are offered without registration and in violation of the Act, *see* Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869, 875-81 (1959). These criminal and civil liabilities also may be imposed where private offering purchasers act as conduits for distribution of securities to the general public.

19. *See* note 15 *supra*.

ditionally has been thought to include offerings in which the investor's need for protection by the Act's disclosure requirements is slight, such as bank loans, placements with large institutions and promoter financing of business ventures.[20] Since the statutory materials provide only a general sketch of the ambit of the exemption, one must consider interpretations by the SEC and, of course, judicial decisions to find a thread of predictability.

The first major administrative interpretation of the private offering exemption was released by the SEC in 1935.[21] While expressing the opinion that the question essentially was a factual one, the Commission enumerated four factors considered important in granting an exemption:[22] (1) the number of offerees[23] and their relationship to one another and to the issuer; (2) the number of units offered; (3) the size of the offering;[24] and (4) the manner of the offering.

Eighteen years later, the United States Supreme Court in *SEC v. Ralston Purina Co.*[25] established a broad private offering test without directly relying on SEC releases. *Ralston Purina* involved an attempt to distribute some five hundred shares of company stock to "key employees" under a stock option plan. The key employee recipients included loading dock foremen and others who had virtually no knowl-

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20. H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).
21. Securities Act Release No. 33-285, 11 Fed. Reg 10952 (1935).
22. Id.
23. The number of offerees often has been an important consideration in ascertaining whether the exemption is available but seldom has been conclusive. 4 L. Loss, SECURITIES REGULATION 2644 (Supp. 1969); Fooshee and McCabe, *Private Placements—Resale of Securities: The Crowell-Collier Case*, 15 BUS. LAW. 72, 73 (1959). *See, e.g.*, Knapp v. Kinsey, 249 F.2d 797 (6th Cir. 1957) *cert. denied*, 356 U.S. 935 (1958), (offering to approximately 300 persons held private); SEC v. Sunbeam Gold Mines, 95 F.2d 699 (9th Cir. 1938); Hirtenstein v. Tenney, 252 F. Supp. 827 (S.D. N.Y. 1966), (offering to one person is not per se private); and Schimer v. Webster, 225 A.2d 880 (D.C. Cir. 1967) (offering to 100 persons held to be public). The current relevance of numbers remains uncertain. *See* Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); Strahan v. Pedroni, 387 F.2d 730 (5th Cir. 1967); and Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959).

Note that the number which is relevant is not the number of actual purchasers, but the number of persons to whom the security is offered. United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); SEC v. Royal Hawaiian Management Corp., [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,982 (C.D. Cal. 1967).
24. The size of the offering is perhaps the least important consideration today. 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 2.2 (1972); Value Line Fund v. Marcus, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,523 (S.D. N.Y. 1965) (private placement of several million dollars held exempt).
25. 346 U.S. 119 (1953). *Accord*, Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); Lundquist v. Turner, 407 F.2d 857 (9th Cir. 1969), *noted in* 48 NW. U.L. REV. 771 (1954) and 21 U. CHI. L. REV. 113 (1953).

edge of the financial position of their employer. The Supreme Court held that in order for the exemption to apply, the offeror must prove that the offerees had knowledge of such investment information as registration would disclose, or that they had access to such information and did not need the protection of the Act because they could fend for themselves.[26] Applying this test to the facts before it, the Court found that certain offerees lacked both knowledge of, and access to, relevant information about the issuer.[27]

Since *Ralston Purina* the trend has been to limit the availability of the exemption. The broad knowledge-access-needs test was refined by the Second Circuit Court of Appeals in *Gilligan, Will & Co. v. SEC.*[28] That court suggested that the governing fact in proving an exemption was whether the offerees were in such a "position" so as to either actually have had such information as registration would have disclosed or have had access thereto.[29] This ambiguous reference to "position" has created uncertainty as to whether the exemption *requires* that the offeree have a position of power, such as a high management position or a major stockholding, sufficient to compel the disclosure of relevant investment information or whether access to such information without a position of power is sufficient.[30] A narrow reading of *Hill York*

26. *Ralston Purina,* 346 U.S. at 125:

> Since exempt transactions are those as to which "there is no practical need for [the Act's] application," the applicability of [4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

27. *Id.* at 126.

28. 267 F.2d 461 (2d Cir. 1959). (Although the primary issue here was whether defendants should be deemed "underwriters," there was considerable general discussion of private offering law.)

29. *Id.* at 466:

> [The Supreme Court in *Ralston Purina*] held that the governing fact is whether the persons to whom the offering is made are in such a position with respect to the issuer that they actually have such information as a registration would have disclosed, or have access to such information thereto.

30. 2 S. Goldberg, Private Placements and Restricted Securities § 2.4(b) (1972). Uncertainty as to the relevance of "position" to "access" has its roots in SEC Release No. 285, *supra* note 21, which stressed the importance of "special knowledge" on the part of "high executive officers." *See* Orrick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act,* 21 U. Pitt. L. Rev. 1, 9-10 (1959).

In *Gilligan* "access" may be read as either dependent or not dependent upon position. Thus, it is unclear whether an issuer can meet the access requirement by voluntarily supplying the financial data which registration would require. For cases which discuss the access requirement, *see* SEC v. Continental Tobacco, 463 F.2d 137 (5th Cir. 1972) (court adopted the *Hill York* dicta which arguably requires special position); Hill York

Corp. v. American International Enterprises,[31] a recent Fifth Circuit decision, suggests that some sort of position of power vis-à-vis the issuer, and not access alone, may be required.[32]

Recent cases also have examined the sophistication of the investor in determining the applicability of the exemption. The Tenth Circuit stated in *Lively v. Hirschfeld*[33] that the exemption would not extend to persons who may have possessed *some* investment expertise where they were not shown to possess exceptional business experience and where they had no actual knowledge of or access to corporate records which would allow that expertise to be exercised. In *United States v. Custer Channel Wing Corp.,*[34] the Fourth Circuit held that financial sophistication is no substitute for access. On the other hand, in *Value Line Fund, Inc. v. Marcus,*[35] the district court for the Southern District of New York held, *inter alia,* that because the parties were sophisticated, knowledgeable investors they could "fend for themselves" and therefore the exemption was available. The Fifth Circuit has added further uncertainty to the sophistication standard by suggesting that although an offering to a select group of high executive officers of the issuer who knew each other and had thorough knowledge of the offering is apt to support the exemption, it might not.[36] There was no

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Corp. v. American Int'l Franchises, 448 F.2d 680 (5th Cir. 1971) (the court intimated that only where the offerees have a special position can the exemption be certain); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971); United States v. Custer Channel Wing Corp., 376 F.2d 675,678 (4th Cir. 1967) (the court emphasized access to information without mentioning position); Value Line Fund Inc. v. Marcus [1964-1965 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,523, ¶ 94,570 (S.D.N.Y. 1965) (the court warned that an insistence that all offerees in a private placement have positions affording them access to corporate records might shut off the offering to all but key employees of the issuer).

31. 448 F.2d 680 (5th Cir. 1971).

32. The *Hill York* decision is particularly disturbing because of its suggestion that only where the offerees are insiders is the offering likely to qualify under the exemption:

> [W]here the number of offerees is so limited that they may constitute a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection, then the exemption is available.

448 F.2d 680, 688 n.6 (5th Cir. 1971). This dicta was adopted by the court in *SEC v. Continental Tobacco* as the test of whether an exemption should be granted. For a discussion of the *Continental Tobacco* case, *see* text accompanying notes 37-42 *infra.*

33. 440 F.2d 631 (10th Cir. 1971), *noted in* 1971 DUKE L. J. 1071.

34. 376 F.2d 675, 678 (4th Cir. 1967).

35. [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91.523, ¶ 94.956 (S.D.N.Y. 1965). Although the primary issue was whether defendants should be deemed underwriters, the decision dealt extensively with the private offering exemption.

36. Hill York Corp. v. American Int'l Franchises, 448 F.2d 680 (5th Cir. 1971).

indication which, if any, more diverse and less sophisticated classes of investors might qualify.

The latest addition to the puzzling series of private offering cases, *SEC v. Continental Tobacco,*[37] led to some speculation that the exemption was being restricted out of existence by the courts.[38] Beginning in May 1969, and continuing through October 1970, Continental Tobacco Company offered securities to at least thirty-eight persons, including a dentist, housewives and businessmen who had no relationship with Continental other than as shareholders subsequent to purchase. One of the offerees, a dentist, testified that because of his enthusiasm for the offering he left Continental's prospectus lying on his desk for his patients to peruse. During this entire period no registration statement was in effect. As a defense to an SEC action to enjoin the distribution of securities without registration, Continental asserted the private offering exemption. Reversing the lower court decision for the defendants,[39] the Fifth Circuit held that since no special relationship assuring access to information was shown as to all offerees, no exemption was established. Additionally, the court held that since Continental could not prove the exact number of persons to whom it made offers, and since it also failed to show that all known offerees had actual access to information, it could not lawfully rely on the exemption.[40] While apparently adopting the most restrictive test to date, the decision is open to various interpretations.[41] The

37. 463 F.2d 137 (5th Cir. 1972), *noted in* 50 TEXAS L. REV. 1447 (1972), and 22 CATH. U. L. REV. 491 (1973).

38. BNA SEC. REG. L. REP. No. 144, *The Disappearing Private Offering Exemption?* B1, B6 (March 22, 1972), *infra* note 41.

39. SEC v. Continental Tobacco, 326 F. Supp. 588 (S.D. Fla. 1971).

40. SEC v Continental Tobacco, 463 F.2d at 161 (5th Cir. 1972). The burden of proving the availability of the exemption is placed upon the party seeking the benefit of the exemption. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); Hill York Corp. v. American Int'l Franchises, 448 F.2d 680 (5th Cir. 1971); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959); SEC v. Sunbeam Gold Mines Corp., 95 F.2d 699 (9th Cir. 1938). If this burden is not carried as to *all* offerees or purchasers, the exemption will be lost. *See* Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

41. For example, the case may stand merely for the proposition that issuers must present some minimum amount of proof as to the number of offerees as a precondition to establishing the exemption. It also may be read as requiring access to information to all offerees. Finally, it may embody a rule that an offeree must be "tantamount to an 'insider' vis-à-vis the issuer" as the SEC contended in its brief, BNA SEC. REG. L. REP. No. 144 at B-5 (1972). Supportive of the latter interpretation is the court's adoption of the dicta in *Hill York* as a test which arguably requires that a special relationship be shown to come within the exemption. *See Continental Tobacco,* 463 F.2d at 159. For a discussion of *Hill York, see* notes 31 and 32 and accompanying text *supra.*

holding which requires identification of all offerees appears particularly onerous because it establishes an insurmountable burden of proof. It is unlikely that Continental could have proven to whom its offerees, notably the enthusiastic dentist, showed the pro forma prospectus. Yet all of those who read it might have been considered offerees. As a result of this case, private offerors may be faced with the very difficult challenge of controlling the use of their pro forma prospectuses. Clearly some sort of limitation on this burden of proof requirement is needed lest even more issurers be discouraged from private financing of capital projects.[42]

As former Chairman Casey of the Securities and Exchange Commission recently stated,[43] "For forty years there has been great doubt as to what constitutes the private offering exemption." Although recent cases have purported to define and restrict the exemption, this basic uncertainty remains. The access to information and ability to fend for oneself tests of *Ralston Purina*[44] have proved too vague to guide the lower courts. Hence, the availability of the exemption has become essentially a question of fact to be determined in each case. It is unclear what role sophistication and investment experience is to play in the decision; some courts have found sophistication irrelevant, while others have held that a high degree of sophistication might substitute for access.[45] Some courts deem the number of offerees a major factor, yet an offering to one person may be deemed a public offering.[46] Most courts require that an offeree have "access" to information, but there is disagreement as to whether "access" requires more than the spoon feeding of information to the offeree, *i.e.*, whether "access" requires that the offeree enjoy a position of power sufficient to force disclosure if

42. Under one possible solution, the unsolicited promotion of securities by purchasers would not be considered actions on behalf of the issuer but rather as actions of volunteers. If any civil liability to the issuer were to result, a complaining securityholder would have to show a principal-agent relationship between issuer and soliciting purchaser.

43. Remarks of former Chairman Casey, [Current] CCH FED. SEC. L. REP. ¶79,108 (1972). The commentators have critized the exemption relentlessly. *See* Harrison, *Thirty-Eight Years Without Definition—The Private Offering Exemption*, 24 U. ARK. L. REV. 417 (1971); Israels, *Some Commercial Overtones of Private Placements*, 45 VA. L. REV. 851 (1959); Victor and Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869 (1959); Sargent, *Private Offering Exemption*, 21 BUS. LAW. 118 (1965); Steffen, *Private Placements Should Be Registered*, 43 N.C.L. REV. 548 (1965); Comment, 86 HARV. L. REV. 403 (1972).

44. *See* note 26 and accompanying text *supra*.

45. *See* notes 32 and 33 and accompanying text *supra*.

46. Hirtenstein v. Tenney, 252 F. Supp. 827 (S.D.N.Y. 1966).

necessary.[47] In addition, large and small issuers are uncertain whether the exemption has been restricted out of existence by recent Fifth Circuit decisions in actions brought by the SEC.[48]

The tenuous status of the private offering exemption has had an inhibiting influence on the free flow of capital to all businesses, but particularly to smaller, less well established firms. So long as the exemption is in doubt, investment bankers and institutions are justifiably hesitant to raise funds for small, new firms whose risky offerings are likely to receive harsh treatment in the courts. Current law does not necessarily assure an exemption where only institutions or banks are offerees. Further, the new issuer is hesitant to seek funds from smaller investors because of these investors' reputed inability to fend for themselves and because of the possibility that their individual acts may destroy the private nature of the offering.[49] The very real need for clarity in defining the exemption has sparked two proposed amendments which will be examined in the remainder of this note.

II. THE PROPOSED FEDERAL SECURITIES CODE APPROACH

The first proposal, a statutory provision drafted by Professor Loss, is contained in the first draft of his ALI Federal Securities Code.[50] The pertinent provisions of the Proposed Code would exempt an offering from registration where fairly specific criteria are met. The offering must qualify as a "limited offering," that is:[51]

> (1) . . . one in which . . . (A) the initial buyers are institutional investors and not more than thirty-five other persons . . . [and] (C) the original offeror and all sellers . . . comply with any rule [adopted by the SEC].

Additionally, "general advertising" by an offeror or reseller is made unlawful.[52]

The Proposed Code responds to the proof problems caused by

47. *See* note 30 *supra*.
48. *See* notes 32, 37 and 41 and accompanying text *supra*.
49. *See* note 42 and accompanying text *supra*.
50. ALI Federal Securities Code (Tent. Draft No. 1, 1972) (hereinafter referred to as Proposed Code).
51. *Id.* § 227(b).
52. *Id.*

the current law's emphasis on offerees[53] by limiting its protection to buyers only. As the comments to the Proposed Code indicate, "it is difficult to see how an offeree who does not buy is hurt" by the failure to register.[54] Thus the offeror's liability for unjustifiably relying on the exemption would be limited to those actually injured. The Proposed Code's prohibition of "general advertising" apparently reiterates current law which inquires into the public or private appearance of the offering[55] in order to reduce the likelihood that persons in need of the Act's protection will be exposed to private offering opportunities. The Proposed Code would leave the exact definition of "general advertising" to the rule-making discretion of the SEC, and, because such advertising is deemed a violation rather than an exemption prerequisite, the possibility that a minor violation of this provision would give rise to rescission or damages is avoided.

The limited offering provision of the Proposed Code requires the participation of one or more institutional investors for the distribution to qualify for an exemption.[56] This provision presumably adopts the rationale that since institutions characteristically avoid high-risk investments, subordinating small investor choice to institutional choice will substitute for the Securities Act. Thus, the institution's presumably "safe" investment decision rather than disclosure through registration would operate to safeguard the investor. This protection provision contravenes an underlying premise of the Securities Act—that protection of investors is to be achieved by assuring adequate disclosure of material investment information rather than by statutorily dictating investment decisions[57]—and could stultify private offering investments by tying investor choice to institutional choice and seriously restrict the flow of capital to new and high-risk enterprises.

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53. *Ralston Purina,* 346 U.S. at 125.

54. Proposed Code § 227, comment (2)(b). The SEC's Proposed Rule 146 continues to emphasize the issuer-offeree relationship.

55. *See* Chapman v. Dunn, 414 F.2d 153, 160-61 (6th Cir. 1969); Strahan v. Pedroni, 387 F.2d 730, 731-32 (5th Cir. 1967); Value Line Fund v. Marcus, [1964-1966 Transfer Binder] CCH FED. SEC L. REP. ¶ 91,523, ¶ ¶ 94,970-71 (S.D.N.Y. 1965).

56. Proposed Code § 227(b)(1)(a) defines limited offerings as those made to "institutional investers *and* not more than thirty-five other persons." (emphasis added) Although this requirement would constitute a major change in the law, the Code curiously makes no mention of its rationale.

57. 1 L. LOSS, SECURITIES REGULATION 184-86 (2d ed. 1961).

Furthermore, the institutional investor requirement of the Proposed Code in fact might not protect the small co-investor. The Proposed Code would allow thirty-five unsophisticated small investors to participate in a private offering regardless of disclosure or ability to compel disclosure. It is foreseeable that institutions will protect themselves contractually vis-à-vis the offeror without regard to, and perhaps to the detriment of, the interests of small investors.[58] In addition, small investors might purchase a private offering security in reliance on an issuer's prediction of fast growth and quick return, misled by an institution which may have determined that fast growth and quick return is unlikely but which still purchased with a view toward long-term investment. It is important also to recognize that the prohibition against "general advertising" and the numerical investor limits contained in the Proposed Code do not by themselves protect those thirty-five noninstitutional investors who ultimately are persuaded to purchase private offering securities. The "general advertising" provision will prevent the use of public channels of communication in private offerings, but a large number of potential investors may be reached through private channels. News of investment opportunities can travel long distances and reach many investors through no advertising other than a few "hot tips." Furthermore, issuers have an uncanny way of quickly contacting persons with "loose" investment capital.

Aside from the unfortunate institutional investor requirement and the resulting inadequate protection of investors, the Proposed Code represents a healthy step forward in securities law. Its emphasis on purchasers rather than offerees eliminates sticky proof problems[59] while its flat thirty-five person limit avoids current uncertainties as to the numerical size of the offering[60] and eliminates the vague "access" test.[61]

58. The problem of inconsistent contractual protection easily could be solved by requiring that such protection extend to all investors. Query, however, whether some institutions would force small investors out of offerings rather than share their protections.

59. *See* note 40 and accompanying text *supra*.

60. *See* note 24 *supra*.

61. *Ralston Purina*, 346 U.S. at 125.

III. SEC PROPOSED RULE 146

A second proposal for clarifying the exemption is the SEC's Proposed Rule 146, issued November 28, 1972.[62] Rule 146 is based upon a determination by the SEC that the crucial elements in establishing the private offering exemption are access to information similar to that which registration would disclose and an ability of offerees to fend for themselves without the protections of registration. The Rule would require that an offeror seeking its protection meet six conditions. First, the securities must be offered and sold in a "negotiated transaction" without the use of any form of "general advertising."[63] Second, before offering a security the issuer must have reasonable grounds to believe (1) that the offeree has knowledge and business experiences sufficient to allow him to evaluate investment risks and make an informed decision, and (2) that the offeree is "able to bear the economic risks of his investment."[64] Third, during the course of the transaction the offeree must have the "same kind" of information which formal registration would disclose or have "access" to such information and "access" to any additional information needed to verify its accuracy.[65] Fourth, the number of purchasers in any twelve-month period may not exceed thirty-five persons,[66] exclusive of persons purchasing for cash in excess of $250,000. Fifth, the issuer carefully must limit redisposition of the securities through specified reasonable actions.[67] Sixth, the issuer is required to file reports of sales made under this Rule.[68]

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62. SEC Proposed Rule 146, 37 Fed. Reg. 26140 (1972).
63. *Id.*
64. *Id.*
65. *Id.*
66. Subsection (a)(1)(ii) of the Proposed Rule defines "person" as excluding "any corporation, partnership, business association or other unincorporated entity organized for the specific purpose of the acquisition of the securities offered in the transaction." However, "each beneficial owner of an equity interest in or equity securities of any such person is deemed a separate person for purposes of this section." Application of this Rule might exclude from private offerings an important source of capital for new enterprises—investment partnerships in which one party has unlimited investment discretion. SEC Proposed Rule 146, 37 Fed. Reg. 26140 (1972).
67. Proposed Rule 146 at (g)(1), (2). The Proposed Rule requires, but is not limited to, the following actions:
(1) Placing legend or other certificate on securities stating lack of registration and restrictions on transferability,
(2) Issuing stop-transfer instructions to the issuer's transfer agent,
(3) Obtaining from purchaser a signed written agreement not to sell the securities "without compliance with the act and rules and regulations thereunder."
68. *Id.* Within forty-five days after the end of any quarter of the issuer's fiscal year

Because the Rule does not provide an exclusive definition of the exemption,[69] an issuer who cannot meet its conditions may still take his chances on a favorable judicial construction. Although the Rule provides no shelter from the anti-fraud provisions of the Act[70] or civil liability,[71] satisfaction of its conditions would assure an issuer protection from SEC registration requirements and registration-related liability.[72]

The Proposed Rule must be applauded as a step in the direction of clarity. Its standards are more objective than those presently existing and should infuse more certainty into this area, thereby encouraging the free flow of private capital. As the Commission states in its comments to the Rule:[73]

> . . . [t]he lack of objective standards in the private placement area may be hindering the raising of capital by new businesses that are not sufficiently seasoned to attract investment banking firms willing to underwrite public offerings of their securities.

However, should this Rule be adopted, many uncertainties would remain within the Rule itself and in the penumbral area outside of its protection still subject to judicial tests.

The first uncertainty involves the requirement of a negotiated transaction. The Commission's comments state that personal contact or communication which provides an opportunity to ask questions of and receive answers from the issuer or its representative must take place.[74]

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during which sales of securities are effected in reliance on this rule, the issuer must file a report of sales made under the Rule. Failure to report results in loss of the protection of the Rule, which is an unduly harsh result. The Rule should be modified to provide for a minor penalty, such as a $250 fine for each missed report.

69. SEC Notice of Proposed Rule 146, File No. S7-458, [Current] CCH FED. SEC L. REP. ¶ 79,108 (1972): "The Proposed Rule does not establish exclusive standards for complying with the Section 4(2) exemption . . . ."

70. 15 U.S.C. § 77a (1970); "It shall be unlawful for any person in the offer or sale of any securities by the use of . . . interstate commerce or by the use of the mails. . . (1) to employ any device, scheme, or artifice to defraud . . . ."

71. 15 U.S.C. §77*l* (1970) provides:

> Any person who . . . (a) offers or sells a security (whether or not exempted by [Section 4(2)] . . . which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . . not misleading and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the [purchaser] . . . .

72. 15 U.S.C. § 77e (1970).

73. [Current] CCH FED. SEC. L. REP. ¶ 79,108, ¶ 82,398 (1972).

74. *Id.* ¶ 82,401.

Just what an issuer must do to afford such an opportunity is problematic. If offerees, known to be knowledgeable and able to fend for themselves, are mailed offering circulars which include an invitation to ask questions of the issuer, will this, without more, be considered a true opportunity to ask questions and receive answers, or will it be viewed merely as an empty gesture? It is foreseeable that a more overt opportunity such as an actual meeting with time for questions and answers, or actual evidence of bargaining such as communication of registration-type information pursuant to request might be required. It is doubtful that the negotiated transaction requirement adds to the protection of investors afforded elsewhere in the Proposed Rule by its "bear the risk"[75] and "access"[76] requirements.

The requirement that the offeror have reasonable grounds to believe that a potential offeree or his representative is financially sophisticated and that the offeree can "bear the risk" of the investment[77] may greatly discourage reliance on the Rule. The "reasonableness" of the offeror's grounds for believing that a person's business expertise is adequate under the Rule necessarily will be evaluated after the offeror experiences a financial setback. The indices of financial sophistication are sometimes quite subtle, and where an investment seems especially desirable to the offeree, he probably will make every effort to appear sophisticated if he knows his ability to invest hinges on such an appearance. However, when his investment turns sour, the offeree may be expected to reverse his earlier claim of sophistication and complain to the Commission. Meeting this requirement potentially could force the issuer to secure investor representation letters, to perform background searches of prospective offerees and to secure proof of each search, since the burden of proof undoubtedly would continue to rest on the issuer.

Similar problems could arise in establishing reasonable grounds for belief that an offeree can bear the risk of his investment. This requirement might discourage both those investors whose net assets, although sufficient to undergo the risk safely, are much less than they would like others to know, and those affluent investors who prefer to maintain financial privacy for other reasons. Additionally, it is not

75. *See* text accompanying note 64 *supra*.
76. *See* text accompanying note 65 *supra*.
77. *See* note 64 *supra*.

self-evident what relation between investment and net assets a person must have to be able to "bear" the risks of an investment. Does "bear" mean to be able to maintain one's standard of living or does it mean to be able to avoid personal bankruptcy if the investment were lost? Assuming that bankruptcy did result from a loss of all or part of the investment, would a presumption arise that the issuer did not make a reasonable inquiry into the investor's financial position? As to many offerees, issuers would be forced to undertake extremely thorough inquiries in order to ensure compliance with this requirement. It also is questionable whether a financially sophisticated investor with limited resources, such as a high executive officer of the issuer, should not be able to decide for himself the advisability of incurring a risk. Thus, the "bear the risk" requirement should not be adopted because it precludes small investors who desire to invest in a private offering where they are knowledgeable in a business sense and have sufficient information to make an informed investment decision.

The access-to-information requirement of the Proposed Rule is couched in the same vagaries which have so long characterized the private offering exemption in the courts. It is unclear just how much information or how much access will be necessary. The Proposed Rule requires that the "same kind" of information be available as that provided through registration. However, it does not appear to require access to the *exact* information which registration would disclose, presumably because information required in identical situations might vary among SEC examiners. The Proposed Rule's use of the term "access" without definition continues a current ambiguity. This "access" provision of the Proposed Rule probably requires informal full disclosure, that is, opening up one's books to full investor inspection. Until "access" is defined, the Proposed Rule will remain seriously imprecise.

Another serious problem with the Rule is its apparent ratification of the *Continental Tobacco* requirement of proof of the issuer's dealings with all offerees.[78] As mentioned above, this requirement poses almost insurmountable problems of proof which would continue to seriously restrict use of the exemption even if the Proposed Rule was

78. *See* text accompanying note 41 *supra*.

adopted. A more realistic approach would remove entirely the emphasis on offerees. As Professor Loss has noted, it is difficult to see how an offeree who does not purchase suffers injury.

IV. AN ALTERNATIVE APPROACH

A clear private offering exemption rule is needed in order to enable new enterprises to raise capital without resort to public registration. As a guide for the SEC and the courts, such a rule should provide predictability and reduce the risk of civil rescission for conscientious issuers. Protection of investors must be the major concern of the Commission, however, and cannot be sacrificed for the sake of clarity. Proposed Rule 146 and the Proposed Federal Securities Code must be rejected because neither ensures both clarity and protection of investors.

The Commission should reject Proposed Rule 146 because it lacks the clarity essential to a workable rule. Proposed Rule 146 will not resolve current serious ambiguities because it does not define "access," "sophistication" and "ability to bear a risk." The investment community will not rely on a rule which basically reiterates vague judicial tests.

The Proposed Federal Securities Code is a model of clarity, but it does not assure adequate protection of investors and therefore is not a viable alternative to Proposed Rule 146. Its protections are inadequate because they would allow unsophisticated small investors to participate blindly in private offerings provided that an institution—whose interests are likely to be at odds with those of the small investor—also participates. Furthermore, the Proposed Code makes no provision for assuring that the small investor will adequately understand the nature of his investment risk.

Adequate protection of investors and clarity can be achieved through the adoption of a rule which carefully includes in private offerings those investors who can fend for themselves vis-à-vis the issuer and excludes those who cannot. This writer recommends a private offering rule which, while not excluding others who can meet relevant judicial tests, clearly allows as investors within any twelve-month period:

(1) Banks, Insurance Companies, Mutual Funds, Pension Funds and other Investment Companies; provided that financial statements of

the most recent year show such companies to have net assets in excess of $500,000;

(2) Issuer's "insiders" defined as: (a) not more than twenty executives who indicate in writing that they have a "working knowledge" of the issuer's financial condition, that is, that because of their position as employees they have day to day familiarity with material financial information, (b) general partners and (c) owners of at least twenty percent of a corporation's voting stock; and/or

(3) Investors other than those included under (1) above who purchase securities for a price in excess of $250,000, provided the investor and his attorney indicate in writing the investor's desire to forego the protection of registration.

Provided that:

(1) After reasonable inquiry issuer and his agents are not aware of circumstances indicating that the purchasers are underwriters and that appropriate steps are taken to assure that a deferred distribution is not made, including: (a) placing a legend on the document evidencing the security and indicating that the security is not registered and cannot be transfered without registration or compliance with an available exemption; (b) issuing of stop transfer instructions to the transfer agent; and (c) obtaining a written agreement from the purchaser that the securities will not be resold without registration or compliance with the Act.

This proposed rule exempts from registration offerings to purchasers who by virtue of their economic or managerial power can fend for themselves vis-à-vis the issuer. There should be no doubt that financial institutions can "fend for themselves," provided that they have substantial financial resources. Therefore, this proposed rule assumes that institutions with net assets above $500,000 have sufficient investment expertise and financial bargaining power to force disclosure and impose desired contractual protections. Also, the offeror may determine whether a given institution is eligible by simply asking for an audited financial statement. The inclusion of up to twenty of the issuer's "insiders" enables small enterprises to raise capital internally where feasible. This avoids the anomaly of forcing a company to prepare financial reports to be sent to Washington, D.C., so that adequate disclosure will be assured when it seems clear that SEC registration cannot add materially to what a company insider knows about that firm. This rule contemplates that the term "executive" would exclude persons not contributing services to the enterprise, thereby precluding schemes in which securities are sold to otherwise unprotected investors via a psuedo-executive facade. It does not attempt to decide precisely what quantum of services would be required, leaving this detail to subsidiary rule-making and adjudication. The requirement that qualifying executive purchasers affirm in writing their working knowledge of the issuer's financial position prevents such executives from later successfully attacking the offering as nonprivate. Here the need for protection is slight, and the need for clarity great. Lastly, the "other investor" provision allows large individual investors to participate in the benefits of private offerings, but only after express waiver of the protections of registration.

In sum, this proposed rule could achieve the clarity which is absent in Proposed Rule 146 and the protection of small investors which is absent in the Proposed Federal Securities Code.

S.M.L.